Saumitra Chaudhuri

Member, Economic Advisory Council to the Prime Minister and Economic Advisor, ICRA Limited

India – Prospects for sustaining high growth

Club CEPII

CEPII and EIEBG

Paris

Friday, September 12, 2008

The Last 12 Months

- This is a difficult time for most economies and certainly India is not an exception
- Inflation rates that were upwardly mobile, soared, due to a big run-up in prices of crude oil and other commodities; headline rates have risen from 5% to above 12%
- Growth has slowed since the middle of fiscal 2007/08 (Q3 of calendar 2007)

Saumitra Chaudhuri

Near-term outlook is problematic

- Double whammy from unwinding of sub-prime boom & then from the price surge in oil & other commodities has extended the outlook for adverse economic conditions well into 2009
- Growth still relatively strong & food inflation is under control, though corporate margins are under pressure and financing investment is much tougher
- It could be regarded as a cyclical development within another (global) cycle
- However, there is yet life in 2009 and beyond …..

3

Saumitra Chaudhuri

India story – *The Transformation*

A view of how the Indian economy has fared, and what has changed in the broader market expectations …….

4

What's changed in the India story?

Macro-Parameters

- Sustained growth rates approaching 9.0%
- Dramatic increase in domestic Investment & Savings Rates
  - Investment rate from 25% (2000) to 37% (2007)
  - Savings rate from 23% (2000) to 36% (2007)
  - Implying – Increased investment financed at home
- Fiscal conditions have improved, though stress points have developed recently from fuel & fertilizer subsidies
- Imports are largely financed by current receipts
- There is a large and young working population

Saumitra Chaudhuri

What's changed in the India story?

Micro-Parameters

- Big improvement in economic productivity and global competitiveness at both the aggregate & enterprise levels
- Balance sheets and profitability of domestic firms improved despite fall in effective import protection
- Manufacturing sector showed a dramatic, and to many observers an unexpected revival
- New enterprises provide the dynamism and life to the business space
- Rise of a previously non-existent empowered & expanding consumer class

Structural changes are many sided

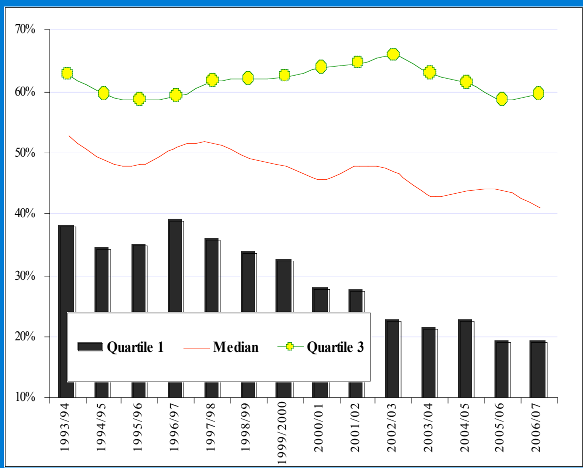
- For things to change, first, people must change
- Outcomes are the fruit of learning & adaptation
  - Supportive macro-policy environment and greater stability in macro-economic conditions
  - Strengthened financial (banks, capital markets) sector
  - Manufacturing corporates have graduated towards global competitiveness
  - Ordinary people have positive expectations
  - Regulators have learned to facilitate more (and not seek to control)

Expectations have been transformed

- Over the past several years, the most dramatic outcome has been the revival of manufacturing companies
- This has fundamentally altered the scope of national economic development
- India, from being a software specialist with an anemic industrial sector to a full-blown continental economic success story

Saumitra Chaudhuri

The revival of Manufacturing (1)



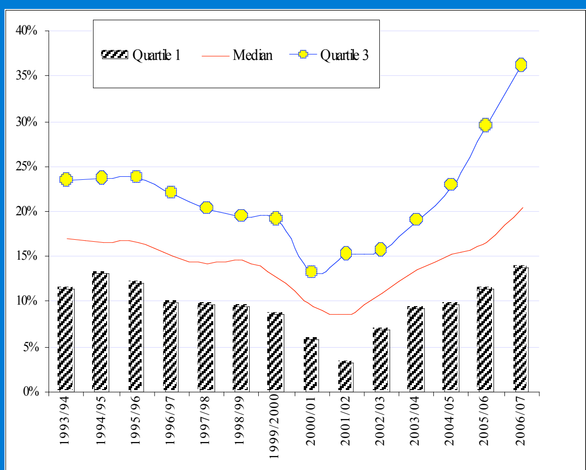
Debt as a proportion of capital employed for manufacturing companies

Decline is steep for top companies

9

Saumitra Chaudhuri

The revival of Manufacturing (2)



Return on Capital Employed shows dramatic improvements

Across the board, but more pronounced for top companies

10

Increase in share of world trade

- India’s share in world trade hit a low of 0.4% in early 1990s. It increased to 1.2% by 2007
- Share in manufactured trade also 1.2% in 2007
- This outcome has taken place in an environment characterized by:
  - Declining import protection and export incentives
  - Some real hardening of the Rupee
- Export growth continues to be strong in 2008/09

The deleveraging phase is over ….

- Leverage was up in 2007/08 due to new investments. Likely to increase further in 2008/09
- With costs eating into margins some decline in profitability likely in current fiscal year.
- Weak capital markets will lead to rise in cost of both debt and equity (fresh issuance pick-up at home and abroad lower than hoped for)
- This in conjunction with weaker business sentiment may adversely affect prospects of new investment

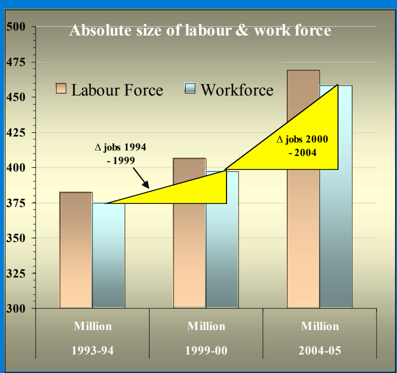
Saumitra Chaudhuri

….while the fiscal balance worsens

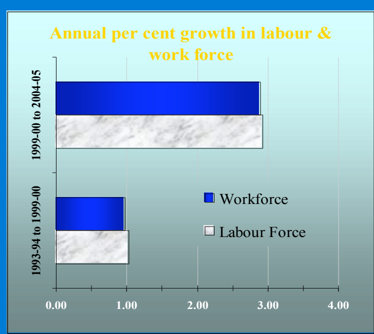
- Due to large fuel & fertilizer subsidies, *plus* public sector pay revisions, farm debt relief and employment guarantee schemes, the central (true) fiscal deficit may be higher by 5 percentage points of GDP compared to the budgeted 2.5%.
- Tax revenue growth still remains strong, but the size of the subsidy burden in 2008/09 has the potential of destabilizing the fiscal consolidation path. To maintain course, serious correctives needed in 2009/10
- Widening of fiscal stance, at a time when the private corporate sector is increasing leverage and the current account deficit is enlarging makes situation trickier

Saumitra Chaudhuri

Job creation has picked up



Critically underscores the importance of raising labor productivity through education



In the second part of the post-1991 reform period, the pace of job creation rose dramatically

Source: EAC Report (2007)

Energy consumption: The big gap

2007 (est.)	Electricity KwH/capita	
	Units	India's position
India *	704	
China **	2,200	32%
Brazil	2,400	29%
Germany	6,400	11%
Japan	8,500	8%
USA	14,500	5%

Note: * 16% Hydro + R/w, 82% Thermal, 2% Nuclear
** For China the figure is for generation

To get to 3,500 units / capita in 25/30 years India will need 750,000 MW of fresh capacity, i.e. about 9% annual growth in generation

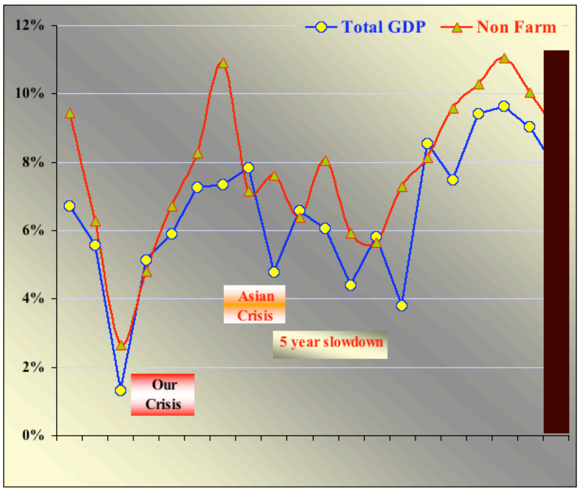
It is a bit more convincing because of: (a) of revival industry; (b) actual progress in infrastructure

Issues in the growth problematic

Can the process of investment and consumption driven growth be a sustainable medium to long term story?

Saumitra Chaudhuri

Question: Is growth here to last?



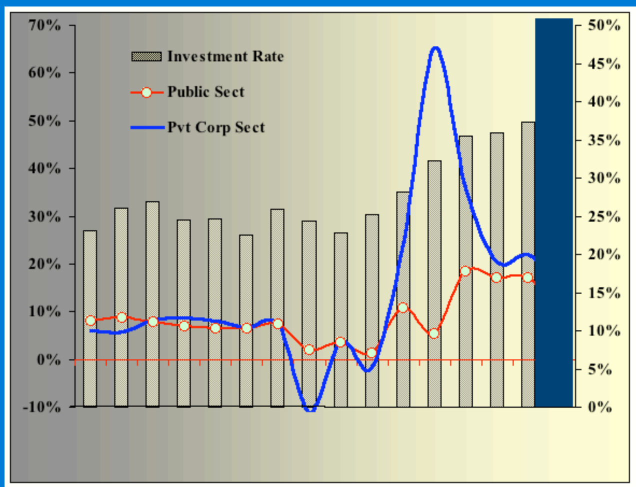
India has gone through 3 phases post-1991: (a) rapid expansion, (b) then slowing & (c) once again a rapid pace of growth.

Is this a cyclical up-turn or is it a break-out?

17

Saumitra Chaudhuri

Big recovery in business investment



Investment by private corporates in current phase of growth has increased dramatically: Ratio to GDP has risen from 6% to 14%

18

External account – some features

Year: 2007/08

- Merchandise Trade Gap: –7.7%
- Services Trade Gap: +3.2%
- Pure Trade Gap: –4.5%
- Net current transfers: +3.5%
- Net Factor Income: –0.5%
- Current account: –1.5%
- Capital account: +9.2%

Oil prices & Inflation takes toll

- Headline inflation rate has jumped from 5% to over 12%; likely to remain at this level rest of 2008, and decline in early 2009.
- Global capital market sentiments very negative
- Which will result in pushing back expansion of Indian corporate investment in India & elsewhere
- However, present negative sentiment should yield to a positive re-assessment of strong fundamentals
- We should see a revival of conditions conducive to growth in fiscal 2009/10.

Principal challenges ahead for India

- The Indian economy continues to be supply constrained
  - Physical infrastructure – Challenge #1
  - Social infrastructure – Challenge #2
  - Organizational & institutional development, sometimes broadly clubbed under "governance" – Challenge #3
- Dealing with the first two are inextricably linked to the third
- Besides there are significant security challenges in the region

Is growth in India inevitable?

- No longer any serious structural constraints to sustained growth which will be driven largely by domestic demand.
- Sustaining high growth rates is partly dependent on favorable global economic conditions
- Main downside economic risk derives from the 3-fold challenges spelt out earlier
- In the longer term it is a matter of relative pace:
  - I.e. a difference of +/– 5 years over a 25 year period
  - As long as a growth shock does not have a lasting effect and drives medium-term growth down towards 5%

Consistency with other parameters

- What may seem to be inevitable, however rarely turns out to be so, or in the manner expected
- Energy & material needs for expanded output levels, impact on prices in near-term and effects on environment in the longer-term, create a complex setting – outcomes are difficult to judge
- However, clearly significant technological improvements in energy and material use are important pre-requisites for sustaining high growth

Opportunity for investors

- For a savvy investor a good point to enter is before the upturn – that is, when asset prices are down and negotiating power is with the investor
- Expect this kind of investor to be active in balance part of 2008 and early 2009
- Institutional plays likely to have to wait till the return of some degree of confidence in global equity markets
- In the connected world of today change happens with blinding speed

Challenge to Policy Making

- The year 2008 has posed an unprecedented challenge to our policy makers; also for other emerging economies
- Most are still growing relatively fast, face severe inflationary pressure; some are also under fiscal & financial pressure.
- In the Indian case, political developments centering around the Indo-US agreement for civil nuclear energy has created conditions where the prickly conditions normally preceding elections (due early 2009) have been accentuated.

Thank you

For your patience